

**COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER**

FINANCIAL STATEMENTS

WITH AUDITORS' REPORT

JUNE 30, 2004 AND 2003

**COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER**

JUNE 30, 2004 AND 2003

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INDEPENDENT AUDITORS' REPORT

The Honorable Board of Supervisors
County of San Bernardino, California:

We have audited the accompanying financial statements of the Arrowhead Regional Medical Center (Medical Center), a fund of the County of San Bernardino (County), as of and for the years ended June 30, 2004 and 2003, as listed in the accompanying table of contents. These financial statements are the responsibility of the Medical Center's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Note 1 of the notes to the financial statements, the financial statements present only the Medical Center and do not purport to, and do not, present fairly the financial position of the County as of June 30, 2004 and 2003, and the changes in its financial position and cash flows, where applicable, for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Medical Center as of June 30, 2004 and 2003, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 17, 2004 on our consideration of the Medical Center's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The Medical Center has not presented management's discussion and analysis that accounting principles generally accepted in the United States of America has determined is necessary to supplement, although not required to be part of, the basic financial statements.

Vavumik. Tuni. Day ; Co, LLP

Rancho Cucamonga, California
September 17, 2004

**COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER**

STATEMENTS OF NET ASSETS

JUNE 30, 2004 AND 2003

(In Thousands)

	<u>2004</u>	<u>2003</u>
ASSETS		
Current Assets		
Cash	\$ 14,472	\$ 5,059
Assets whose use is limited	200	1,387
Patient accounts receivable, net of estimated uncollectibles of \$197,818 in 2004 and \$214,564 in 2003	21,684	30,967
Due from third-party payors	4,340	4,852
Receivables from federal and state programs	41,035	28,511
Due from County	1,119	750
Supplies inventories	1,349	1,235
Prepaid expenses and other assets	377	481
Total Current Assets	<u>84,576</u>	<u>73,242</u>
Assets whose use is limited	58,976	60,207
Capital assets, net of accumulated depreciation of \$133,401 in 2004 and \$110,167 in 2003	474,268	494,965
Deferred issuance costs	9,718	10,347
Total Assets	<u>627,538</u>	<u>638,761</u>
LIABILITIES		
Current Liabilities		
Accounts payable	11,607	12,141
Accrued salaries and benefits	14,186	12,127
Other accrued liabilities	268	249
Capital lease obligations	354	289
Certificates of participation	23,060	21,890
Interest payable	13,653	14,108
Arbitrage payable	25	107
Due to County	28,907	19,318
Total Current Liabilities	<u>92,060</u>	<u>80,229</u>
Capital lease obligations, less current installments	1,305	-
Certificates of participation, less current installments (net of deferred amount of refunding and discount)	560,917	581,735
Total Liabilities	<u>654,282</u>	<u>661,964</u>
NET ASSETS (LIABILITIES)		
Invested in capital assets, net of related debt	(101,651)	(98,602)
Restricted for debt service	45,523	47,357
Unrestricted	29,383	28,042
Total Net Liabilities	<u>\$ (26,744)</u>	<u>\$ (23,203)</u>

See accompanying notes to basic financial statements.

**COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER**

STATEMENTS OF REVENUE, EXPENSES, AND CHANGES IN NET ASSETS

YEARS ENDED JUNE 30, 2004 AND 2003

(In Thousands)

	2004	2003
OPERATING REVENUES		
Net patient service revenue	\$ 372,815	\$ 320,240
Premium revenue - managed care	9,164	11,171
Other	4,563	4,729
Total Operating Revenues	<u>386,542</u>	<u>336,140</u>
OPERATING EXPENSES		
Salaries and benefits	140,294	124,965
Medi-Cal matching fund expense	110,514	94,511
Medical claims expense	1,447	1,289
Supplies	52,827	47,568
Professional services	31,648	33,884
Purchased services	20,567	22,792
Insurance	4,107	3,161
Provision for bad debts	23,197	20,297
Utilities	6,333	6,450
Depreciation and amortization	23,328	24,792
Rent	2,996	2,121
Amortization related to debt	2,871	3,046
Other	3,810	3,577
Total Operating Expenses	<u>423,939</u>	<u>388,453</u>
Operating Loss	<u>(37,397)</u>	<u>(52,313)</u>
NONOPERATING REVENUES (EXPENSES)		
State debt service funding	22,166	29,735
State realignment funding	16,484	29,483
Tobacco tax	1,447	2,920
Investment income	440	5,956
Interest expense on debt	(33,129)	(34,143)
Other nonoperating revenues	6,720	-
Other nonoperating expenses	(946)	(665)
Total Nonoperating Revenues, Net	<u>13,182</u>	<u>33,286</u>
Loss Before Transfers	<u>(24,215)</u>	<u>(19,027)</u>
Transfers from the County	20,674	21,960
Transfers to the County	-	(3,339)
Total Transfers From the County, Net	<u>20,674</u>	<u>18,621</u>
Changes in Net Assets	(3,541)	(406)
Net Liabilities, Beginning of Year, as restated (Note #15)	<u>(23,203)</u>	<u>(22,797)</u>
Net Liabilities, End of Year	<u>\$ (26,744)</u>	<u>\$ (23,203)</u>

See accompanying notes to basic financial statements.

**COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER**

STATEMENTS OF CASH FLOWS

YEARS ENDED JUNE 30, 2004 AND 2003

(In Thousands)

	<u>2004</u>	<u>2003</u>
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts from customers	\$ 357,364	\$ 313,752
Payments to suppliers	(222,839)	(211,551)
Payments to employees	<u>(138,235)</u>	<u>(123,384)</u>
Net Cash Used in Operating Activities	<u>(3,710)</u>	<u>(21,183)</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
State realignment funding received	16,484	29,483
Tobacco tax received	1,447	2,920
Transfers from the County	20,674	21,960
Transfers to the County	-	(3,339)
Other nonoperating income (expense)	<u>5,774</u>	<u>(665)</u>
Net Cash Provided by Noncapital Financing Activities	<u>44,379</u>	<u>50,359</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
State debt service funding	22,166	29,735
Purchase of capital assets	(2,631)	(1,418)
Proceeds from capital lease obligations	1,791	-
Principal payments on capital lease obligations	(421)	(380)
Principal payments on certificates of participation	(21,890)	(20,850)
Interest paid on debt	<u>(33,129)</u>	<u>(34,549)</u>
Net Cash Used in Capital and Related Financing Activities	<u>(34,114)</u>	<u>(27,462)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Interest on investments	440	5,956
Investment activity, net	<u>2,418</u>	<u>(2,950)</u>
Net Cash Provided by Investing Activities	<u>2,858</u>	<u>3,006</u>
Increase in Cash	9,413	4,720
Cash, Beginning of Year	5,059	339
Cash, End of Year	<u><u>\$ 14,472</u></u>	<u><u>\$ 5,059</u></u>

See accompanying notes to basic financial statements.

**COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER**

STATEMENTS OF CASH FLOWS, Continued

YEARS ENDED JUNE 30, 2004 AND 2003

(In Thousands)

	<u>2004</u>	<u>2003</u>
RECONCILIATION OF OPERATING LOSS TO NET CASH USED IN OPERATING ACTIVITIES		
Operating Loss	\$ (37,397)	\$ (52,313)
Adjustments to reconcile operating loss to net cash used in operating activities:		
Depreciation and amortization	23,328	24,792
Amortization related to debt	2,871	3,046
Provision for bad debts	23,197	20,297
Decrease (Increase) in:		
Patient accounts receivable	(13,914)	(23,788)
Due from third-party payors	512	3,917
Receivables from federal and state programs	(12,524)	12,411
Due from County	(369)	2,373
Supplies inventories	(114)	44
Prepaid expenses and other assets	104	2,897
Increase (Decrease) in:		
Accounts payable	(534)	1,208
Accrued salaries and benefits	2,059	1,581
Other accrued liabilities	(436)	(347)
Arbitrage payable	(82)	-
Due to County	9,589	(17,301)
Net Cash Used in Operating Activities	<u>\$ (3,710)</u>	<u>\$ (21,183)</u>

See accompanying notes to basic financial statements.

**COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER**

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2004 AND 2003

(Dollar Amounts in Thousands)

NOTE #1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. General

The County of San Bernardino (County) Arrowhead Regional Medical Center (Medical Center) is classified as a level II trauma center with eight trauma bays and four additional "swing" trauma rooms that can be used during an emergency. In addition, the Medical Center provides 373 patient beds and has 24 private treatment rooms for diagnosis and treatment of urgent care patients. During fiscal year 2000, the Medical Center assumed the inpatient operations, consisting of 90 beds, from the previously separate Department of Behavioral Health.

The Medical Center is owned by the County, which is a legal subdivision of the state of California charged with governmental powers, and is reflected in the County's comprehensive annual financial report as an enterprise fund. The County's powers are exercised through the Board of Supervisors, which, as the governing body of the County, is responsible for the legislative and executive control of the County.

These financial statements present only the Medical Center and do not purport to, and do not, present fairly the financial position of the County and the changes in its financial position and cash flows, where applicable, in conformity with accounting principles generally accepted in the United States of America.

B. Basis of Accounting

The basic financial statements of the Medical Center are presented using the economic resources measurement focus and the accrual basis of accounting in conformity with accounting principles generally accepted in the United States of America. Revenues are recognized in the period in which they are earned and become measurable. Expenses are recognized in the period in which they are incurred.

Operating revenues include those generated from direct patient care and related support services. Operating expenses include the cost of providing patient care, administrative expenses, and depreciation on capital assets. Revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

C. Accounting Standards

Pursuant to Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the Medical Center has elected not to apply the provisions of all relevant pronouncements of the Financial Accounting Standards Board (FASB) issued after November 30, 1989. The Medical Center applies all applicable GASB pronouncements, as well as statements and interpretations of FASB, the Accounting Principles Board (APB) Opinions, and Accounting Research Bulletins (ARBs) of the Committee on Accounting Procedure, issued on or before November 30, 1989, unless those pronouncements conflict or contradict GASB pronouncements.

**COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER**

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2004 AND 2003

(Dollar Amounts in Thousands)

NOTE #1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

D. Income Taxes

The Medical Center is owned and operated by the County and is exempt from federal and state income tax pursuant to IRC Section 115 and similar provisions of the California Franchise Tax Code and is also exempt from federal and state income tax filing requirements.

E. Charity Care

The Medical Center provides care to patients who meet certain criteria under its charity care policy without charge or at an amount less than its established rates. Because the Medical Center does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue. However, the Medical Center monitors the level of charity care provided. See Note # 5.

F. Net Patient Service Revenue

Net patient service revenue is recorded at established rates less contractual allowances from third-party payors, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

G. Premium Revenue - Managed Care

The Medical Center has agreements with Inland Empire Health Plan (IEHP) and Foundation Health to provide medical services to subscribing participants. Under these agreements, the Medical Center receives monthly capitation payments based on the number of participants, regardless of services actually performed by the Medical Center.

Premium revenue is recognized in the period in which participants are entitled to health care services.

H. Cash

The Medical Center maintains a certain portion of its cash on deposit with the County Treasurer.

I. Assets Whose Use is Limited

Assets whose use is limited represent funds held by a trustee which are legally restricted for bond reserve accounts. Assets whose use is limited that are required for obligations classified as current liabilities are reported as current assets.

COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2004 AND 2003

(Dollar Amounts in Thousands)

NOTE #1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

J. Capital Assets

Buildings, improvements, and equipment with a historical cost over \$5,000 are capitalized. Contributed capital assets are reported at their estimated fair value at the date of donation. Depreciation expense is provided using the straight-line method over the estimated useful lives of the respective classes of capital assets. Equipment under capitalized leases is amortized using the straight-line method over the lesser of minimum lease terms or estimated useful lives. The estimated useful lives for computing depreciation expense are as follows:

Buildings	40 Years
Improvements	3 to 25 Years
Equipment	5 to 20 years

K. Capitalized Interest

The Medical Center capitalizes net interest expense as a cost of property constructed. No amounts were capitalized for the years ended June 30, 2004 and 2003.

L. Supplies Inventories

Supplies inventories are recorded at the lower of average cost or market.

M. Net Assets

Net assets of the Medical Center are classified in three components. *Net assets invested in capital assets net of related debt* consist of capital assets net of accumulated depreciation and reduced by the balances of any outstanding borrowings used to finance the purchase or construction of those assets. *Restricted net assets* are noncapital assets that must be used for a particular purpose, as specified by creditors, grantors, or contributors external to the Medical Center. Restricted net assets are reduced by any liabilities payable from restricted assets. *Unrestricted net assets* are remaining net assets that do not meet the definition of invested in capital assets net of related debt or restricted.

N. Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the basic financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2004 AND 2003

(Dollar Amounts in Thousands)

NOTE #1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

O. Reclassification of Prior Year Amounts

Certain prior year amounts in these financial statements were reclassified to conform to current year presentation.

NOTE #2 - CASH AND ASSETS WHOSE USE IS LIMITED

A. Summary

The Medical Center's cash deposits as of June 30, 2004 and 2003 are summarized as follows:

	2004	2003
Cash	\$ 14,472	\$ 5,059
Cash - assets whose use is limited	13,453	13,470
Total Cash	<u>\$ 27,925</u>	<u>\$ 18,529</u>

The Medical Center's assets whose use is limited as of June 30, 2004 and 2003 is comprised of the following:

	2004	2003
Cash	\$ 13,453	\$ 13,470
Investments	44,952	47,357
Interest receivable	771	767
Total Assets Whose Use is Limited	<u>\$ 59,176</u>	<u>\$ 61,594</u>

B. Cash Deposits

At June 30, 2004 and 2003, the carrying amount of the Medical Center's cash deposits was \$27,925 and \$18,529, respectively, and the bank balance was \$13,453 and \$13,470, respectively. The entire bank balance was collateralized with securities held by the pledging financial institution's trust department at 110 percent of the deposits, in accordance with the State of California Government Code, in the Medical Center's name.

**COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER**

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2004 AND 2003

(Dollar Amounts in Thousands)

NOTE #2 - CASH AND ASSETS WHOSE USE IS LIMITED, Continued

C. Custodial Credit Risk and Fair Value of Investments

Debt proceeds are held by a fiscal agent and have been invested in accordance with applicable debt agreements. Investments that are represented by specific identifiable investment securities are classified as to custodial credit risk categories. Category 1 includes investments that are insured or registered, or securities held by the Medical Center or its agent in the Medical Center's name. Category 2 includes investments that are uninsured and unregistered, with securities held by the counterparty's trust department or agent in the Medical Center's name. Category 3 includes investments that are uninsured and unregistered with securities held by the counterparty's trust department or agent but not in the Medical Center's name. The Medical Center's investments at June 30, 2004 and 2003 are summarized as follows:

Type	Credit Risk Category 2	Carrying Amount at Fair Value
June 30, 2004		
Categorized investments - U.S. government securities	\$ 22,703	\$ 22,703
Noncategorized investments - guaranteed investment contracts		22,249
Total Investments		\$ 44,952
June 30, 2003		
Categorized investments - U.S. government securities	\$ 25,109	25,109
Noncategorized investments - guaranteed investment contracts		22,248
Total Investments		\$ 47,357

NOTE #3 - STATE REALIGNMENT FUNDING

The State of California provides support to the Medical Center through a realignment fund. This realignment funding is provided from vehicle license fees and sales tax collected at the state level and allocated to California's counties. The realignment fund replaces state support previously given for specific purposes such as aid to local municipalities affected by decreased levels of tax support, aid to counties which provide services to medically indigent adults, and aid for unreimbursed medical costs of legalized indigent aliens. The amount to be received by the counties is dependent upon the actual change in sales tax and vehicle license fees. The Medical Center's share of these revenues for the years ended June 30, 2004 and 2003 was \$16,484 and \$29,483, respectively. Because the revenues received are not based upon services provided to patients, they have been classified as nonoperating revenue in the accompanying statements of revenues, expenses, and changes in net assets.

**COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER**

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2004 AND 2003

(Dollar Amounts in Thousands)

NOTE #4 - NET PATIENT SERVICE REVENUE

The Medical Center provides services to eligible patients under Medi-Cal and Medicare programs. For the fiscal years ended June 30, 2004 and 2003, the Medi-Cal program represented approximately 46 percent and 45 percent, respectively, and the Medicare program represented approximately 11 percent and 12 percent, respectively, of the Medical Center's net patient service revenue. Medi-Cal inpatient services are reimbursed at contractually agreed-upon per diem rates and outpatient services are reimbursed under a schedule of maximum allowances. Medicare inpatient services are reimbursed based upon pre-established rates for diagnostic-related groups. Effective August 1, 2000, outpatient services went from a cost reimbursement payment methodology to prospectively determined payments per procedure under a system called Ambulatory Payment Classifications. A three-year transitional payment provision exists to limit the impact of this new payment system. Certain defined capital and medical education costs related to Medicare beneficiaries continue to be paid based on a cost-reimbursement methodology. The Medical Center is reimbursed for cost-reimbursable items at a tentative rate, with final settlement determined after submission of annual cost reports by the Medical Center and audits thereof by the fiscal intermediary. The Medical Center's classification of patients under these programs and the appropriateness of their admissions are subject to an independent review by a peer review organization under contract with the Medical Center. Reports on the results of such audits have been received through June 30, 2000 for Medicare and June 30, 2001, for Medi-Cal. Adjustments as a result of such audits are recorded in the year the amount can be determined.

Senate Bill 855 - California's Senate Bill 855 (SB-855) was passed by the State Legislature and signed into law in 1991. The bill provides for supplemental Medi-Cal payments to hospitals that serve a disproportionately high percentage of Medi-Cal and other low-income patients. SB-855 provides additional funds through a reimbursement rate increase at the Medical Center for each Medi-Cal patient day provided, up to a maximum number of days. The Medical Center received \$116,162 and \$95,678 in SB-855 funds for the years ended June 30, 2004 and 2003, respectively. Because the revenues generated are based upon services provided to patients, they have been classified as net patient service revenue in the accompanying statements of revenues, expenses, and changes in net assets. The program required the Medical Center to contribute matching funds of \$81,114 and \$68,361 for the years ended June 30, 2004 and 2003, respectively, which were recorded as operating expense in the accompanying statements of revenues, expenses, and changes in net assets. The Medical Center recorded receivables of \$33,488 and \$27,053 at June 30, 2004 and 2003, respectively, which were included in receivables from federal and state programs.

Senate Bill 1255 - California's Senate Bill 1255 (SB-1255) was passed by the California Legislature and signed into law in 1989. This bill provides a funding mechanism to assist disproportionate share hospitals to fund budget shortfalls. SB-1255 allows disproportionate share hospitals to make voluntary donations to the state. The state then matches the money received with federal funds and redistributes the funds to the eligible hospitals in the subsequent fiscal year. The Medical Center received \$59,400 and \$51,674 in SB-1255 funds for the years ended June 30, 2004 and 2003, respectively. Because the revenues generated are based upon services provided to patients, they have been classified as net patient service revenue in the accompanying statements of revenues, expenses, and changes in net assets. The Medical Center contributed matching funds of \$29,400 and \$26,150 for the years ended June 30, 2004 and 2003, respectively, which were recorded as operating expense in the accompanying statements of revenues, expenses, and changes in net assets. The Medical Center had no related receivables at June 30, 2004 and 2003.

**COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER**

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2004 AND 2003

(Dollar Amounts in Thousands)

NOTE #4 - NET PATIENT SERVICE REVENUE, Continued

Assembly Bill 915 - California's Assembly Bill 915 (SB-915) was passed by the State Legislature and signed into law in 2002. This bill provides for the payment of a supplemental reimbursement to acute care hospitals owned by certain public entities that provide outpatient services to Medi-Cal beneficiaries. The Medical Center recorded \$6,513 in AB-915 funds for the year ended June 30, 2004, the first year of the program. Because the revenues generated are based upon services provided to patients, they have been classified as net patient service revenue in the accompanying statements of revenues, expenses, and changes in net assets. The Medical Center recorded a receivable of \$6,513 for the year ended June 30, 2004, which was included in receivables from federal and state programs.

NOTE #5 - CHARITY CARE

The Medical Center maintains records to identify and monitor the level of charity care it provides. These records include the amount of charges foregone for services and supplies furnished under its charity care policy. The following information measures the level of charity care provided during the fiscal years ended June 30:

	2004	2003
Charges foregone based on established rates	\$ 279,956	\$ 217,774

NOTE #6 - CAPITAL CONTRIBUTIONS

In 1991, the County Board of Supervisors approved the construction and financing plan of the Arrowhead Regional Medical Center project. The Inland Empire Public Facilities Corporation (Corporation) financed the project through the issuance of Certificates of Participation. The Corporation is a nonprofit public benefit corporation formed on May 30, 1986 to serve the County, including the Medical Center, by financing, refinancing, acquiring, constructing, improving, leasing, and selling buildings, building improvements, equipment, land, land improvements, and any other real or personal property for the benefit of the residents of the County. The Corporation is included in the County's reporting entity as a blended component unit. In fiscal year 1999, the Medical Center Project assets and liabilities were contributed to the Medical Center.

In accordance with the master lease agreement, the County is to make aggregate lease payments each year as consideration for the use and occupancy of the Medical Center in an amount designated to be sufficient to pay the annual principal and interest due with respect to any construction debt outstanding. Senate Bill 1732 (SB-1732) was passed by the California Legislature and signed into law in October 1998. The law permits qualifying medical centers to receive reimbursement, in addition to their Medi-Cal contract reimbursement, for a portion of the debt service of qualified projects. Under SB-1732, the Medical Center estimates that it will receive proceeds equal to 50 percent of the total debt service costs. Amounts received by the Medical Center in SB-1732 funds during fiscal year 2004 and 2003, amounted to \$22,166 and \$29,735, respectively, which are included as nonoperating revenues in the accompanying statements of revenue, expenses, and changes in net assets. The Medical Center had no related receivables at June 30, 2004 and 2003.

**COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER**

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2004 AND 2003

(Dollar Amounts in Thousands)

NOTE #7 -CAPITAL ASSETS

A summary of capital assets activity for the years ended June 30, 2004 and 2003, is as follows:

	Beginning Balance	Additions	Deletions	Ending Balance
June 30, 2004				
Land and improvements	\$ 22,268	\$ 24	\$ -	\$ 22,292
Buildings and improvements	490,581	18	-	490,599
Equipment	92,283	2,567	94	94,756
Construction-in-progress	-	22	-	22
Total Capital Assets, Gross	605,132	2,631	94	607,669
Less Accumulated Depreciation for:				
Land and improvements	(9)	(15)	-	(24)
Buildings and improvements	(52,834)	(12,300)	-	(65,134)
Equipment	(57,324)	(11,013)	(94)	(68,243)
Total Accumulated Depreciation	(110,167)	(23,328)	(94)	(133,401)
Capital Assets, Net	\$ 494,965	\$ (20,697)	\$ -	\$ 474,268
June 30, 2003				
Land and improvements	\$ 22,096	\$ 172	\$ -	\$ 22,268
Buildings and improvements	490,481	100	-	490,581
Equipment	91,137	1,146	-	92,283
Total Capital Assets, Gross	603,714	1,418	-	605,132
Less Accumulated Depreciation for:				
Land and improvements	(6)	(3)	-	(9)
Buildings and improvements	(40,445)	(12,389)	-	(52,834)
Equipment	(44,924)	(12,400)	-	(57,324)
Total Accumulated Depreciation	(85,375)	(24,792)	-	(110,167)
Capital Assets, Net	\$ 518,339	\$ (23,374)	\$ -	\$ 494,965

**COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER**

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2004 AND 2003

(Dollar Amounts in Thousands)

NOTE #8 - TRANSACTIONS WITH THE COUNTY

The Medical Center uses the treasury function of the County and at times maintains a cash overdraft with the County, which can be repaid only through collection of receivables. The Medical Center did not have a cash overdraft as of June 30, 2004 and 2003.

The Medical Center is allocated a portion of the County's overhead costs. Such expenses totaled \$2,883 and \$3,201 for the years ended June 30, 2004 and 2003, respectively, and are included as operating expense in the accompanying statements of revenues, expenses, and changes in net assets.

The Medical Center is allocated a portion of the County's annual debt service requirement on the County's pension obligation revenue bonds. Such amounts totaled \$10,679 and \$8,000 for the years ended June 30, 2004 and 2003, respectively, and are included in transfers to the County in the accompanying statement of revenues, expenses, and changes in net assets.

The Medical Center also receives funds from the County of a fixed amount for care of the County's medically indigent patients.

NOTE #9 - LONG-TERM OBLIGATIONS

The following is a summary of changes in long-term obligations for the fiscal years ended June 30, 2004 and 2003:

		June 30, 2004				
		Beginning Balance	Additions	Reductions	Ending Balance	Due within One Year
Certificates of Participation						
Series 1994		\$ 199,460	\$ -	\$ (4,620)	\$ 194,840	\$ 3,965
Series 1995		133,570	-	(4,695)	128,875	5,840
Series 1996		65,070	-	-	65,070	-
Series 1997		86,650	-	(12,575)	74,075	13,255
Series 1998		176,510	-	-	176,510	-
Total Certificates of Participation, Gross		661,260	-	(21,890)	639,370	23,060
Less						
Deferred amount on refunding		(43,274)	-	1,807	(41,467)	-
Discount on debt		(14,361)	-	435	(13,926)	-
Total Certificates of Participation		603,625	-	(19,648)	583,977	23,060
Capital lease obligations		289	1,817	(447)	1,659	354
Total		\$ 603,914	\$ 1,817	\$ (20,095)	\$ 585,636	\$ 23,414

**COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER**

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2004 AND 2003

(Dollar Amounts in Thousands)

NOTE #9 - LONG-TERM OBLIGATIONS, Continued

		June 30, 2003				
		Beginning Balance	Additions	Deletions	Ending Balance	Due within One Year
Certificates of Participation						
Series 1994		\$ 203,950	\$ -	\$ (4,490)	\$ 199,460	\$ 4,620
Series 1995		137,935	-	(4,365)	133,570	4,695
Series 1996		65,070	-	-	65,070	-
Series 1997		98,645	-	(11,995)	86,650	12,575
Series 1998		176,510	-	-	176,510	-
Total Certificates of Participation, Gross		682,110	-	(20,850)	661,260	21,890
Less						
Deferred amount on refunding		(45,257)	-	1,983	(43,274)	-
Discount on debt		(14,795)	-	434	(14,361)	-
Total Certificates of Participation		622,058	-	(18,433)	603,625	21,890
Capital lease obligations		669	-	(380)	289	289
Total		\$ 622,727	\$ -	\$ (18,813)	\$ 603,914	\$ 22,179

A. Certificates of Participation

The Medical Center's certificates of participation were issued by the Inland Empire Public Facilities Corporation (Corporation).

Certificates of participation at June 30, 2004 consist of the following:

Series 1994

The Medical Center Series 1994 Certificates of Participation were dated February 1, 1994, in the amount of \$283,245, with interest rates from 4.60 percent to 7.00 percent.

The Series 1994 Certificates maturing on August 1, 2005, August 1, 2006, August 1, 2019, August 1, 2024, August 1, 2026, and August 1, 2028, are subject to optional redemption in whole or in part on any date in such order of maturity as the Corporation shall determine and by lot within a maturity, on or after August 1, 2004, at the following premiums, plus interest accrued to the redemption date:

Redemption Dates	Premium
August 1, 2004 to July 31, 2005	2%
August 1, 2005 to July 31, 2006	1
August 1, 2006 and thereafter	-

**COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER**

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2004 AND 2003

(Dollar Amounts in Thousands)

NOTE #9 - LONG-TERM OBLIGATIONS, Continued

The Series 1994 Certificates maturing on August 1, 2000 through August 1, 2004, August 1, 2009, August 1, 2017, August 1, 2020, and August 1, 2022, are not subject to optional redemption prior to maturity.

Series 1995

The Series 1995 Certificates of Participation were dated June 1, 1995, in the amount of \$363,265, with interest rates from 4.80 percent to 7.00 percent.

The Series 1995 Certificates maturing on August 1, 2022, are subject to optional redemption, in whole or in part, on any date in such order of maturity as the Corporation shall determine and by lot within a maturity, on or after August 1, 2005, at the following premiums, plus interest accrued to the redemption date:

<u>Redemption Dates</u>	<u>Premium</u>
August 1, 2005 to July 31, 2006	2%
August 1, 2006 to July 31, 2007	1
August 1, 2007 and thereafter	-

The Series 1995 Certificates maturing on and prior to August 1, 2010 and on August 1, 2017, are not subject to optional redemption prior to maturity.

Series 1996

The Series 1996 Certificates of Participation were dated January 1, 1996, in the amount of \$65,070, with interest rates from 5.00 percent to 5.25 percent.

The Series 1996 Certificates are subject to optional redemption, in whole or in part, on any date in such order of maturity as the Corporation shall determine and by lot within a maturity, on or after August 1, 2006, at the following premiums, plus interest accrued to the redemption date:

<u>Redemption Dates</u>	<u>Premium</u>
August 1, 2006 to July 31, 2007	2%
August 1, 2007 to July 31, 2008	1
August 1, 2008 and thereafter	-

Series 1997

The Series 1997 Certificates of Participation were dated September 1, 1997, in the amount of \$121,095, with interest rates from 4.30 percent to 5.50 percent.

The Series 1997 Certificates are not subject to optional redemption prior to maturity.

**COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER**

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2004 AND 2003

(Dollar Amounts in Thousands)

NOTE #9 - LONG-TERM OBLIGATIONS, Continued

Series 1998

The Series 1998 Certificates of Participation were dated October 22, 1998, in the amount of \$176,510. Interest with respect to the Certificates is payable at an adjustable weekly interest rate, which may be converted to a fixed interest rate at the option of the Corporation. The Corporation entered into an interest rate swap agreement with Merrill Lynch Capital Services, Inc., which provides that the Corporation will pay a fixed rate of 4.1895 percent to the Swap Provider on a notional amount equal to the principal amount of the Series 1998 Certificates, and the Swap Provider will pay interest to the Corporation at a variable rate of interest on such notional amount, such payments to be made on a net basis. See information below.

The Series 1998 Certificates are subject to optional redemption prior to their maturity at a redemption price equal to the principal amount thereof, plus accrued interest to the date of redemption as follows:

- a) Prior to the Conversion Date, fixed interest rate, at a redemption price equal to the principal amount called for redemption without premium.
- b) After the Conversion Date, at a redemption price of 100 percent of the principal amount plus a premium to be determined on or prior to the Conversion Date.

The proceeds from the Series 1998 Certificates of Participation (Certificates) were used for the advance refunding for \$160,700 of previously issued Series 1995 Certificates of Participation. Government securities were purchased with the proceeds, and those securities were deposited in an irrevocable trust with an escrow agent to provide debt service until the remaining outstanding Certificates mature. The advance-refunding method met the requirements of an in-substance defeasance, and the remaining outstanding Certificates were removed as a liability of the Medical Center.

At both June 30, 2004 and 2003, the balance of defeased debt outstanding, but removed from the Medical Center's accounting records, was \$276,770.

Interest Rate Swap

Objective of the interest rate swap. As a means to lower financing costs, and to reduce the risks to the Corporation associated with the fluctuation in market interest rates, the Corporation entered into an interest rate swap in connection with the Medical Center Series 1998 Certificates of Participation (Series 1998 Certificates) in the amount of \$176,510. The intention of the swap was to effectively change the variable interest rate on the bonds to a synthetic fixed-rate of 4.1895 percent.

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NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2004 AND 2003

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NOTE #9 - LONG-TERM OBLIGATIONS, Continued

Terms. The Series 1998 Certificates and the related swap agreement mature on August 1, 2026, and the swap's notional amount of \$176,510 matches the \$176,510 variable-rate COPs. The swap was effective at the same time the Series 1998 Certificates were issued on October 22, 1998. Starting in fiscal year 2008-09, the notional value of the swap and the principal amount of the associated debt decline. Under the swap agreement, through August 1, 2005, the Corporation pays Merrill Lynch a fixed rate of 4.1895 percent and Merrill Lynch pays the Corporation an amount equal to the variable rate interest payable on the outstanding Series 1998 Certificates. After August 1, 2005, the Corporation pays Merrill Lynch a fixed payment of 4.1895 percent and receives from Merrill Lynch a variable payment computed as 73 percent of the monthly London Interbank Offered Rate (LIBOR). Conversely, the Series 1998 Certificates variable-rate coupons have historically been similar to the Bond Market Association Municipal Swap Index (BMA).

Fair Value. Because interest rates have declined since execution of the swap, the swap had a negative fair value of \$4,098 as of June 30, 2004. The swap's negative fair value may be countered by a reduction in total interest payments required under the variable-rate bonds, creating a lower synthetic interest rate. Because the coupons on the variable-rate Series 1998 Certificates adjust to changing interest rates, the Series 1998 Certificates do not have a corresponding fair value increase. The fair value was the quoted market price from Merrill Lynch at June 30, 2004.

Credit Risk. The swap counterparty was rated Aa3 by Moody's and A+ by Standard & Poor as of June 30, 2004. The swap agreement specifies that if the long-term senior unsecured debt rating of Merrill Lynch & Co. is withdrawn, suspended or falls below A- (Standard & Poor) or A3 (Moody's), a collateral agreement will be executed within 30 days or the swap agreement will terminate.

Basis Risk. The swap exposes the Corporation to basis risk should the relationship between LIBOR and BMA converge, changing the synthetic rate on the Series 1998 Certificates. If a change occurs that results in the rates moving to convergence, the expected cost savings may not be realized. As of June 30, 2004, the BMA rate was 1.05 percent, the actual variable interest rate was 1.02 percent, and 73 percent of LIBOR was .9992 percent.

Termination Risk. The Corporation or the counterparty may terminate the swap if the other party fails to perform under the terms of the contract. The swap may be terminated by the Corporation if Merrill Lynch's credit quality rating falls below A- as issued by Standard & Poor or A3 by Moody's. If the swap is terminated, the variable-rate Series 1998 Certificates would no longer carry a synthetic interest rate. Also, if at the time of termination the swap has a negative fair value, the Corporation would be liable to Merrill Lynch for a payment equal to the swap's fair value.

**COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER**

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2004 AND 2003

(Dollar Amounts in Thousands)

NOTE #9 - LONG-TERM OBLIGATIONS, Continued

Swap payments and associated debt. Using rates as of June 30, 2004, debt service requirements of the variable-rate debt and net swap payments, assuming current interest rates remain the same for their term, were as follows. As rates vary, variable rate Series 1998 Certificates interest payments and net swap payments will vary.

Fiscal Year	Variable Rate Bonds		Interest Rate Swaps, Net	Total
	Principal	Interest		
2005	\$ -	\$ 1,800	\$ 5,594	\$ 7,395
2006	-	1,800	5,594	7,395
2007	-	1,800	5,594	7,395
2008	-	1,800	5,594	7,395
2009	1,000	1,795	5,579	8,374
2010-27	175,510	19,440	60,408	255,359
Totals	<u>\$ 176,510</u>	<u>\$ 28,437</u>	<u>\$ 88,365</u>	<u>\$ 293,312</u>

B. Debt Service Requirements

The total annual debt service requirements to maturity for the outstanding certificates of participation as of June 30, 2004 are summarized as follows:

Fiscal Year	Total	
	Principal	Interest
2005	\$ 23,060	\$ 32,367
2006	24,350	31,076
2007	25,735	29,694
2008	27,180	28,247
2009	29,795	26,670
2010-14	82,570	117,552
2015-19	107,355	93,264
2020-24	139,870	61,246
2025-29	179,455	22,473
Totals	<u>\$ 639,370</u>	<u>\$ 442,589</u>

**COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER**

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2004 AND 2003

(Dollar Amounts in Thousands)

NOTE #12 - RETIREMENT PLAN

Employees of the Medical Center participate in a cost-sharing multiple-employer defined benefit retirement plan (the Plan) administered by the San Bernardino County Employee's Retirement Association (SBCERA). The Plan is governed by the San Bernardino Board of Retirement under the California County Employees Retirement Act of 1937 (1937 Act). It provides retirement, death, and disability benefits to members. Employees become eligible for membership on their first day of regular employment and become fully vested after five years. SBCERA issues a stand-alone financial report, which may be obtained by contacting the Board of Retirement, 195 North Arrowhead Avenue, San Bernardino, California 92415-0014.

Participating members are required by statute Sections 31621, 31621.2, and 31639.25 of the California Code to contribute a percentage of covered salary based on certain actuarial assumptions and their age at entry into the Plan. Employee contribution rates vary according to age and classification (general or safety). Members are required to contribute 7.11 percent to 10.58 percent of their annual covered salary, of which the County pays approximately 7 percent. Employers are required to contribute 6.67 percent to 14.46 percent of the current year covered payroll. The Medical Center's pension cost for the fiscal years ended June 30, 2004 and 2003, was approximately \$15,110 and \$9,400, respectively. Employee contribution rates are established and may be amended pursuant to Articles 6.1 and 6.8 of the 1937 Act. Employer rates are determined pursuant to Section 31453 of the 1937 Act. The following table shows the County's required contributions and the percentage contributed for the current year and each of the two preceding years:

<u>Year Ended June 30,</u>	<u>Annual County's Required Contributions</u>	<u>Percentage Contributed</u>
2002	\$ 69,245	100%
2003	68,361	100%
2004	590,661	100%

NOTE #13 - SELF-INSURANCE

The Medical Center participates in the County's self-insurance programs for general liability, unemployment insurance, employee dental insurance, medical malpractice, and workers' compensation claim-related risks.

The activities related to the self-insurance programs are accounted for in the County's Risk Management Funds, separate internal service funds of the County, except for unemployment insurance and employee dental insurance, which are accounted for in the General Fund of the County. The Medical Center participates in these plans through a premium based arrangement that consists of annual amounts not subject to adjustment for adverse claims. Insurance premium expense for the years ended June 30, 2004 and 2003, was \$4,107 and \$3,161, respectively.

**COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER**

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2004 AND 2003

(Dollar Amounts in Thousands)

NOTE #9 - LONG-TERM OBLIGATIONS, Continued

C. Capital Lease Obligations

The Medical Center has various lease agreements with financial institutions and medical equipment manufacturers expiring at various dates through October 2003, providing for monthly payments at various interest rates. Equipment acquired under these agreements have been accounted for as capital leases.

Future minimum lease payments on capital leases as of June 30, 2004, are as follows:

<u>Fiscal Year</u>	
2005	\$ 406
2006	406
2007	406
2008	405
2009	168
Total minimum lease payments	<u>1,791</u>
Less Amount Representing Interest	<u>(132)</u>
Present value of net minimum lease payments	1,659
Less Current Portion of Capital Lease Obligations	<u>(354)</u>
Capital lease obligations, excluding current portion	<u><u>\$ 1,305</u></u>

The net book value of equipment acquired under capitalized leases at June 30, 2004 and 2003 was \$1,440 and \$270 (net of accumulated amortization of \$360 and \$3,999), respectively.

NOTE #10 - ARBITRAGE PAYABLE

Interest earned in excess of interest expense related to tax-exempt debt issued for public purposes must be remitted to the federal government following the end of each period of five bond years of the Certificates of Participation. The amount of excess investment earnings calculated as of June 30, 2004 and 2003, totaled \$25 and \$107, respectively.

NOTE #11 - OPERATING LEASES

Rent expense for operating leases for the years ended June 30, 2004 and 2003, totaled \$787 and \$766, respectively.

**COUNTY OF SAN BERNARDINO
ARROWHEAD REGIONAL MEDICAL CENTER**

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2004 AND 2003

(Dollar Amounts in Thousands)

NOTE #12 - RETIREMENT PLAN

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Participating members are required by statute Sections 31621, 31621.2, and 31639.25 of the California Code to contribute a percentage of covered salary based on certain actuarial assumptions and their age at entry into the Plan. Employee contribution rates vary according to age and classification (general or safety). Members are required to contribute 7.11 percent to 10.58 percent of their annual covered salary, of which the County pays approximately 7 percent. Employers are required to contribute 6.67 percent to 14.46 percent of the current year covered payroll. The Medical Center's pension cost for the fiscal years ended June 30, 2004 and 2003, was approximately \$15,110 and \$9,400, respectively. Employee contribution rates are established and may be amended pursuant to Articles 6.1 and 6.8 of the 1937 Act. Employer rates are determined pursuant to Section 31453 of the 1937 Act. The following table shows the County's required contributions and the percentage contributed for the current year and each of the two preceding years:

<u>Year Ended June 30,</u>	<u>Annual County's Required Contributions</u>	<u>Percentage Contributed</u>
2002	\$ 69,245	100%
2003	68,361	100%
2004	590,661	100%

NOTE #13 - SELF-INSURANCE

The Medical Center participates in the County's self-insurance programs for general liability, unemployment insurance, employee dental insurance, medical malpractice, and workers' compensation claim-related risks.

The activities related to the self-insurance programs are accounted for in the County's Risk Management Funds, separate internal service funds of the County, except for unemployment insurance and employee dental insurance, which are accounted for in the General Fund of the County. The Medical Center participates in these plans through a premium based arrangement that consists of annual amounts not subject to adjustment for adverse claims. Insurance premium expense for the years ended June 30, 2004 and 2003, was \$4,107 and \$3,161, respectively.

**COUNTY OF SAN BERNARDINO
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NOTES TO FINANCIAL STATEMENTS

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(Dollar Amounts in Thousands)

NOTE #14 - LITIGATION

The Medical Center is the defendant in various lawsuits and other claims arising in the ordinary course of its operations. In the opinion of County Counsel and County officials, the ultimate outcome of these matters will have no significant effect on the financial condition or operations of the Medical Center.

NOTE #15 – RETAINED EARNINGS RESTATEMENT

In the year ended June 30, 2003, the Medical Center understated the liability for compensated absences, which resulted in a restatement of net assets. The restatement decreased net assets as previously reported at June 30, 2003, by \$619. Operating expenses at June 30, 2003, increased by \$619.

NOTE #16 – MEDI-CAL STATE PLAN AMENDMENT

In May 2003, the Office of the Inspector General (“OIG”), U.S. Department of Health and Human Services, completed a review of the State of California's implementation of certain limits pertaining to the Medi-Cal disproportionate (“DSH”) share hospital payments program for the fiscal year ended June 30, 1998. In the review, the OIG performed alternative calculations relating to the interpretation of the OBRA 1993 limits versus the State Plan methodology. Should the alternative calculations be deemed to supercede the State Plan methodology, it is possible that some portion of the DSH funds received by the hospital may be considered overpayments. While a Medi-Cal State Plan Amendment regarding the manner in which the OBRA 1993 limits are calculated and applied in California was approved by the Centers for Medicare and Medicaid Services (“CMS”) in 1996, CMS also stated that estimates made under this amendment would be subject to future adjustment. It is unknown what impact this may have on the hospital.